CERTIFIED PUBLIC ACCOUNTANT

FOUNDATION LEVEL 2 EXAMINATIONS

F2.2: ECONOMICS AND THE BUSINESS ENVIRONMENT

THURSDAY, 01 DECEMBER 2022

MODEL ANSWERS

QUESTION ONE

MARKING GUIDE

	Marks
a) Types (2 marks each x4= 8 marks)	8
b) Explanation of equilibrium price(1mark)	1
Graph (1 mark)	1
Price determination (1 mark)	1
Indifference in demand and supply (1 mark)	1
Decision of the consumers and suppliers in rise and follow of price (1mark)	1
c) 1mark for showing the equality between S&D	1
Equilibrium price (1 Mark)	1
Equilibrium Quantity (1Mark)	1
d) Sources of internal economies of scale (0.5 marks each. Maximum of 2 marks) 2 Sources of external economies of scale (0.5 marks each, maximum of 2 marks)	2
Total	**20**

Model Answers

a. The four types of economic systems

1. Free Market Market/Market Economy/Capitalist

In a market economic system or a free market system, communities, firms and proprietor's self-interest to decide how to allocate and distribute resources what to produce and who to sell to. Governments in market systems typically have little interventions on how businesses operate and generate income however can regulate factors like fair trade, policy development and honest business operations. Market economic systems can benefit emerging businesses and sole proprietorships.

2. Socialist/command/Centrally planned economic system

The decisions are made by the Government. The Government makes plans about what to produce, how to produce and for whom to produce. Therefore, resources are allocated by the Government through a system of planning. This system is governed by one central authority and its aim is social welfare. Prices here are fixed by central authority. The government intervenes in production processes to regulate fair trade agreements and ensure compliance with international policy. Additionally, governments in a centrally planned economy take part in coordination efforts to provide public services. This type of economic system is an offshoot of the command economy,

where governments still maintain a level of control over the allocation and distribution of resources.

3. Traditional economic system

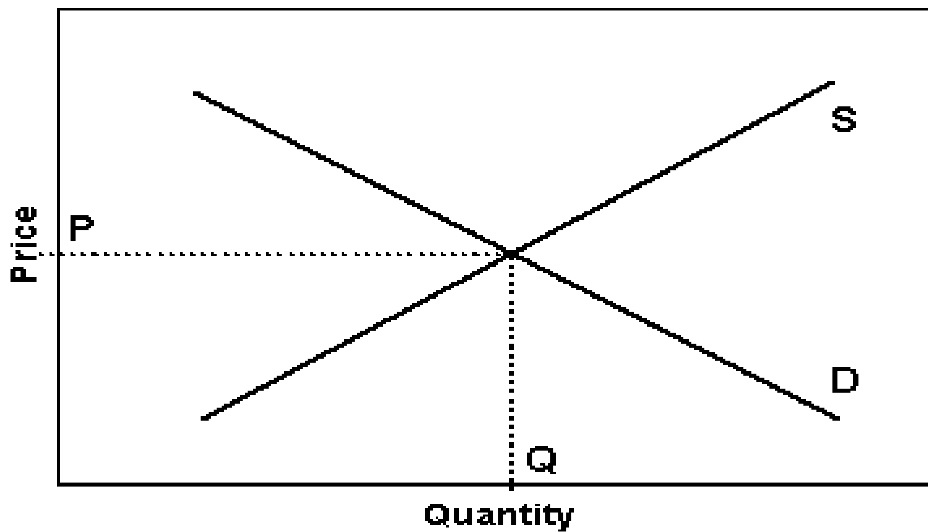
In traditional economic system, each member of a community or society has a specific role that contributes to the whole progress of the community. Traditional economic systems represent to the oldest model where societies are more physically connected and socially satisfied through labor, farming and other simple processes. While traditional economic systems can have several benefits such as (rarely any surplus in goods or resources and community members are generally more satisfied in social roles) and also have several potential drawbacks like lack of growth and technology development, less focus on industrialized production and more focus on agricultural processes, antiquated methods of distribution and reliance on localized resources and services inhibits globalization

4. Mixed economic system

Mixed systems combine the characteristics of the market and command economic systems. For this reason, mixed systems are also known as dual systems. Sometimes the term is used to describe a market system under strict regulatory control. Most industries are private, while the rest, composed primarily of public services, are under the control of the government. Supposedly, a mixed system combines the best features of market and command systems. However, practically speaking, mixed economies face the challenge of finding the right balance between free markets and government control. Governments tend to exert much more control than is necessary.

b. Demand and supply determine market price in Rwanda case

When a product exchange occurs, the agreed upon price is called an equilibrium price, or a market clearing price. Graphically, this price occurs at the intersection of demand and supply as presented below:



In the above figure, both buyers and sellers are willing to exchange the quantity Q at the price P. At this point, supply and demand are in balance. Price determination depends equally on demand and supply.

At any price below P, the quantity demanded is greater than the quantity supplied. In such a situation, consumers would be shouting for a product that producers would not be willing to supply; a shortage would exist. In this event, consumers would choose to pay a higher price in order to get the product they want, while producers would be encouraged by a higher price to bring more of the product onto the market.

The end result is a rise in price, to P, where supply and demand are in balance. Similarly, if a price above P were chosen arbitrarily, the market would be in surplus with too much supply relative to demand. If that were to happen, producers would be willing to take a lower price in order to sell, and consumers would be induced by lower prices to increase their purchases. Only when the price falls would balance be restored. A market price is not necessarily a fair price; it is merely an outcome. It does not guarantee total satisfaction on the part of buyer and seller.

c. The equilibrium price and the equilibrium Quantity

As at equilibrium Sp= DP

-400+100P =2000-50P

100p+50p=2000+400

150P=2400

P=$\frac{2400}{150}$

P=16

The equilibrium price is 16

Sp=-400+100P
Sp=-400+(100*16)
Sp=-400+1600
Sp=1200
DP=2000-50P
DP=2000-(50*16)
DP=2000-800
DP=1200
The equilibrium quantity is 1200

d. Sources of internal and external economies of scale

i. Source of internal economies of scale

- Mass production through manufacturing capability improved by process improvements or application of technology and innovation
- Discounts received from bulk purchases of supplies or raw materials used as inputs in production or from special agreements with suppliers
- Multiple production or delivery of different goods or services using similar production processes resulting in higher collective output and profitability
- Specialization of tasks made possible from financial capability used in hiring a larger workforce or using better tools resulting in better productivity
- Spreading the fixed cost association in the management or administration of an organization across a higher level of output or large production volume
- Inexpensive or cost efficiency advertising and marketing expenditures relative to profits from high profitability from large production volume

ii. Sources of external economies of scale

- Expansion of an industry or sector leading to an increase in marginal returns although involved organizations individual produce under constant returns to scale
- Government intervention such as tax breaks or discounts to attract organization, thus resulting in lesser cost in doing business to a particular location
- Effective transportation networks that make the movement of supplies or distribution of outputs time and cost effective and efficient
- Availability of highly competent individuals in the labor market of a particular location, thus leading to lower hiring and retention cost
- Geographic locations with favorable characteristics such as transportation networks, competent labor market, and infrastructures or public services

QUESTION TWO

Marking Guide	**Marks**
a) Forms of market structure and one example	
Forms (2 marks each x 4= 8 marks, maximum of 8 marks)	8
Example (0.5 marks each x 4= 2, maximum of 2 marks)	2
b) Pareto efficiency in individual consumption	
Introduction	2
Graph	2
Interpretation	1
c. Sources of barriers to enter into a Rwandan market	
Explanation of each Sources (1 mark each, maximum of 5 marks)	5
Total	**20**

Model Answers

a. Four forms of market structure and one example for each form

Perfect Competition: In a perfect competition market structure, there are a large number of buyers and sellers. All the sellers of the market are small sellers in competition with each other. There is no one big seller with any significant influence on the market. So all the firms in such a market are price takers.

Example: Agriculture: In this market, products are very similar. Carrots, potatoes, and grain are all generic, with many farmers producing them.

Monopolistic Competition: This is a more realistic scenario that actually occurs in the real world. In monopolistic competition, there are still a large number of buyers as well as sellers. But they all do not sell homogeneous products. The products are similar but all sellers sell slightly differentiated products. Now the consumers have the preference of choosing one product over another. The sellers can also charge a marginally higher price since they may enjoy some market power. So, the sellers become the price setters to a certain extent.

For example: the market for cereals. The products are all similar but slightly differentiated in terms of taste and flavours.

Oligopoly**:** In an oligopoly, there are only a few firms in the market. While there is no clarity about the number of firms, 3-5 dominant firms are considered the norm. So, in the case of an oligopoly, the buyers are far greater than the sellers. The firms in this case either compete with another to

collaborate together, they use their market influence to set the prices and in turn maximize their profits. So the consumers become the price takers. In an oligopoly, there are various barriers to entry in the market and new firms find it difficult to establish themselves.

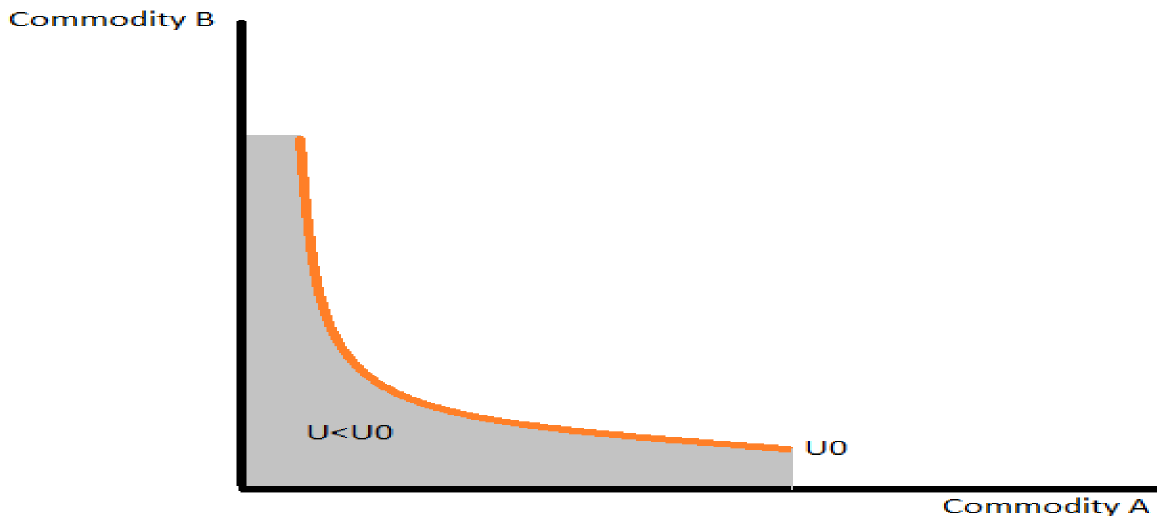
Example: the automobile industry

Monopoly: In a monopoly type of market structure, there is only one seller, so a single firm will control the entire market. It can set any price it wishes since it has all the market power. Consumers do not have any alternative and must pay the price set by the seller. Monopolies are extremely undesirable. Here the consumer loses all their power and market forces become irrelevant. Example: Microsoft company

b. Pareto efficiency in individual consumption

In consumer behavior, a consumption bundle is pareto efficient if it is impossible to increase a consumer's consumption of one good without decreasing the consumer's consumption of some other good. An allocation of resources in the economy is economically efficient (now called Pareto efficient) if it is impossible to reallocate the resources so as to make at least one person feel better off without making someone else feel worse off.

Graphically, it implies that a consumer always consumes on the border of his indifference set and not at its interior. All points in the exterior of the indifference set give the consumer more utility but they are infeasible as the consumer cannot afford them



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A Pareto efficient consumption bundle always lies on the indifference curve. In the graph above, the grey shaded area represents the less than set for the indifference curve (orange curve) U0. All points in the interior region give strictly less utility than a point on the indifference curve.

c. Five sources of barriers to entry into a Rwandan market

- **Economies of scale**: These are declines in the unit costs of a product as the absolute volume per period increases. These forces the entrant to either come in at a large scale as risking strong reaction from incumbents or a small scale like forcing a cost disadvantage.

- **Product differentiation:** Incumbents have brand identification and customer loyalties. this forces entrants to spend heavily to overcome these loyalties. Startups may bring a different product to market but its benefits must be clearly communicated to the target customer. Startups must find an effective positioning which often requires marketing resources beyond their means.

- **Capital requirements**: These are the financial resources required for infrastructure, machinery, Research and development and advertising. Startups may get around capital requirements by outsourcing parts of the operation to companies that can leverage existing investments

- **Access to distribution channel:** This can be a barrier if logical distribution channels have been locked up by incumbents

- **Government policy:** Government can limit or prevent entry to industries with various controls for example licensing requirements, limits to access to raw materials. Startups in highly regulated industries will find that incumbents have fined-tuned their business according to regulation

QUESTION THREE

Marking Guide

		Marks
a)	Assumptions (2 marks each x 6= 12 marks, maximum of 12 marks)	12
b)	Factors (2 marks each x 4= 8 marks, maximum 8)	8
Total		**20**

Model Answers

a. The marginal productivity theory of distribution

- **Perfect competition in both product and factor markets:** Firstly, the theory assumes the perfect competition in both product and factor markets. It means that both the price of the product and the price of the factor say labour remains unchanged.

- **Operation of the law of diminishing returns:** Secondly, the theory assumes that the marginal product of a factor would diminish as additional units of the factor are employed while keeping other factors constant.

- **Homogeneity and divisibility of the factor:** Thirdly, all the units of a factor are assumed to be divisible and homogeneous. It means that a factor can be divided into small units and each unit of it will be of the same kind and of the same quality.

- **Operation of the law of substitution:** Fourthly, the theory assumes the possibility of the substitution of different factors. It means that the factors like labour, capital and others can be freely and easily substituted for one another. For example, land can be substituted by labour and labour by capital.

- **Profit maximization**: Fifthly, the employer is assumed to employ the different factors in such a way and in such a proportion that he gets the maximum profits. This can be achieved by employing each factor up to that level at which the price of each is equal to the value of its marginal product.

- **Full employment of factors:** Sixthly, the theory assumes full employment for factors. Otherwise, each factor cannot be paid in accordance with its marginal product. If some units of a particular factor remain unemployed, they would be then willing to accept the employment at a price less than the value of their marginal product.

- **Exhaustion of the total product**: Finally, the theory assumes that the payment to each factor according to its marginal productivity completely exhausts the total product, leaving neither a surplus nor a deficit at the end.

b. Four factors influence the determination of wage rate in Rwanda

The wage payment is an important factor influencing labour and management relations. Workers are very much concerned with the rates of wages as their standard of living is connected with the amount of remuneration they get. Managements generally, do not come forward to pay higher wages because cost of production will go up and profits will decrease to the extent.

Wage determination factors

- **Ability to Pay:** The ability of an industry to pay will influence wage rate to be paid, if the concern is running into losses, then it may not be able to pay higher wage rates. A profitable enterprise may pay more to attract good workers. During the period of prosperity, workers are paid higher wages because management wants to share the profits with labour.
- **Demand and Supply.** The labour market conditions or demand and supply forces to operate at the national and local levels and determine the wage rates. When the demand for a particular type of skilled labour is more and supply is less than the wages will be more. One the other hand, if supply is more demand on the other hand, is less then persons will be available at lower wage rates also. According to Mescon," the supply and demand compensation criterion is very closely related to the prevailing pay comparable wage and on-going wage concepts since in essence to all these remuneration standards are determined by immediate market forces and factors.
- **Prevailing Market Rates:** No enterprise can ignore prevailing wage rates. The wage rates paid in the industry at the same place will form a base for fixing wage rates. If a unit or concern pays low rates, then workers leave their jobs whenever they get a job somewhere else. It will not be possible to retain good workers for long periods.
- **Cost of Living**: In many industries wages are linked to enterprise cost of living which ensures a fair wage to workers. The wage rates are directly influenced by cost of living of a place. The workers will accept a wage which may ensure them a minimum standard of living. Wages will also be adjusted according to price index number. The increase in price index will erode the purchasing power of workers and they will demand higher wages. When the prices are stable, then frequent wage increases may not be required
- **Bargaining of Trade Unions**: The wage rates are also influenced by the bargaining power of trade unions. Stronger the trade union, higher will be the wage rates. The strength of a trade union is judged by its membership, financial position and type of leadership.
- **Productivity**: Productivity is the contribution of the workers in order to increase output. It also measures the contribution of other factors of production like machines, materials, and management. Wage increase is sometimes associated with increase in productivity. Workers may also be offered additional bonus, etc., if productivity increases beyond a certain level. It is common practice to issue productivity bonus in industrial units.
- **Government Regulations:** To improve the working conditions of workers, government may pass a legislation for fixing minimum wages of workers. This may ensure them, a minimum level of living. In under developed countries bargaining power of labour is weak and employers try to exploit workers by paying them low wages. In India, Minimum Wages Act, 1948 was passed

empower government to fix minimum wages of workers. Similarly, many other important legislations passed by government help to improve the wage structure.

- **Cost of Training:** In determining, the wages of the workers, in different occupations, allowances must be made for all the exercises incurred on training and time devoted for it.

QUESTION FOUR

Marking Guide

	Marks
a) Reason explained (2 marks each x 4=8 marks, maximum of 8)	8
b) Economic implication of indirect taxation	
Positive (2 marks each x 2= 4 marks, maximum of 4)	4
Negative (2 marks each x 4= 4 marks, maximum of 4)	4
c) Automatic fiscal stabilizers (1 mark for Introduction + 2 mark for explanation+ 1 mark for example= 4 marks)	4
Total	**20**

Model Answers

a. Reason why Governments across the world try to shield their industries from international competition

Protectionist measures are usually aimed at:

- **Nationalism:** Nationalistic feeling or patriotism requires that people of a country should buy products of their domestic industries rather that foreign products
- **Employment argument:** Leading to increase in domestic employment or at least preserves present that foreign products
- **Infant industries argument:** Infant industries should be provided protection from the competition
- **Anti-dumping Argument:** Foreign producers compete unfairly by dumping the goods in another country. Dumping is a form of price discrimination when producers of a country sell goods in another country at lower prices than those charged at home
- **Maintaining Balance of Trade or trade surplus:** If a country exports more than it imports, it has a trade surplus. This means that more currency is flowing into your country than flowing out and this currency can pay domestic wages and fuel business expansion

- **Restricting imports:** Helps in developing industries can add to the country's economy growth, increase the overall wealth of the country and lead to a better balance of trade
- **Redistribution of income:** by providing protection to domestic producers, their profits can be raised at the expense of consumers who suffer a loss in consumer surplus as protection denies them consumption of low-priced imported goods. That is protection redistributes income in favor of domestic procedures

b. Four economic implications of indirect taxation in Rwandan economy

An indirect tax is collected by one entity in the supply chain usually a producer or retailer and paid to the government but it is passed on to the consumer as part of the purchase price of a good or service. The consumer is ultimately paying the tax by paying more for the product. Indirect tax has both positive and negative implications in Rwandan economy. A few implications are shown below:

i. Positive indirect taxation in the Rwanda economy context

✓ **Freedom of choice**: whereas an increase in the rate of personal tax reduces a wage earner's net disposable income, an increase in indirect taxation leaves earning unaltered and a wage earner can choose whether or not he wishes to buy the goods and services subjects to higher tax rates.
✓ **Voluntary payment**: Payment of indirect taxes is voluntary in the sense that, consumers can choose to avoid expenditures on taxed goods and services. For instance, if an individual does not smoke or drink, he does not pay any tax on these items.
✓ **Means of reaching the poor**: It is a sound principle that every individual should pay something little to the state. The poor who are always exempted from paying taxes are reached only through indirect taxes.
✓ **Administration Indirect taxes offer certain administrative advantages**. Customer and exercise duties are paid by importers and manufactures while sales tax are collected from wholesalers and retailers. Those officials on whom the customs and exercise are concerned have to keep on check are comparatively few compared with very large number of people who pay direct taxes. Hence indirect taxes are more difficult to evade and easier to collect than direct taxes.

Selectivity Indirect taxes may be used selectively to achieve particular aim. For example, they can be used as instrument of checking the consumption of harmful commodities. Examples are tobacco, wine, beer and so on which are heavily taxed.

ii. Negative implications of indirect taxation in the Rwanda economy context

✓ **Regressive in nature**: Indirect taxes are regressive in sense that; they fall more heavily on people with low incomes than those with high incomes. The poorer tend to spend a greater proportion of their income on buying goods and services so they pay a greater proportion of their income in indirect taxes.

✓ **Uncertain in yield**: They are uncertain in yield unless necessities are taxed. In case of goods with elastic demand, the tax might not bring in much revenue. The tax will raise the price and contract the demand when the commodity is not purchased, the question of tax payments does not arise.

✓ **Cost of living**: An increase in indirect tax can raise retail prices and hence the cost of living of the consumer of the product.

✓ **Uneconomical**: Indirect taxes are not economical from the taxpayer's point of view, since he may, in fact; pay more than the amount actually received by the state that is profit margins may receive a concealed increase.

c. Automatic fiscal stabilizers

Automatic stabilizers are the way in which elements of government fiscal activity automatically increase or decrease in response to changes in the overall economic activity of a country, it refers to elements, built into government revenues and expenditures, that reduce fluctuations in economic activity without the need for discretionary government actions.

They mainly consist of two elements: changing tax revenues and changing welfare payments, though import levels can also play a role. Tax and welfare spending contain the most dramatic automatic stabilizers. When the economy is in good shape, businesses are doing well, and employment levels are high, the government tends to take in more money from taxes such as income and corporation taxes. Contrarily, these revenues fall when economic activity declines. At the same time, welfare payments tend to have an inverse relationship to overall economic activity: a slump or recession means more unemployment and thus higher overall welfare payments.

A key element of automatic stabilizers is that the factors change not only in raw numbers, but as a percentage of overall economic activity, usually measured as gross domestic product. This is not true of all forms of taxation. For example, while the amount collected in sales tax will rise or fall in line with economic activity specifically how much people have available to spend, the proportional relationship between total sales tax take and GDP is much more consistent. The main advantage of using automatic stabilizers is stability. The combination of tax and welfare spending means that when the economy is doing well, it is likely that overall more money will move from individuals and business to the government while when the economy is in poor shape then overall more money will move from the government to individuals. This should mean that booms and slowdowns are both tempered meaning extreme swings in the economy are less likely.

QUESTION FIVE

Marking Guide

		Marks
a.	Differences (2 marks each x2= 4 marks, maximum of 4 marks)	4
b.	Causes explained (2 marks each x 3= 6marks, maximum of 6 marks)	6
c.	Control Controls (0.5 marks each, maximum of 2 marks)	2
d.	Relationship between inflation and unemployment using Philips curve	2
marks for Explanation		2
marks on graph		2
Marks for interpretation		2
Total		**20**

Model Answers

a.

i. The difference between creeping and galloping inflation

- **Creeping Inflation**: This is also known as mild inflation or moderate inflation. This type of inflation occurs when the price level persistently rises over a period of time at a mild rate. When the rate of inflation is less than 10% annually, or it is a single digit inflation rate, it is considered to be a moderate inflation. This kind of mild inflation makes consumers expect that prices will keep going up. That boosts demand. Consumers buy now to beat higher future prices. That is how mild inflation drives economic expansion.

-**Stagflation**: It is an economic situation in which inflation and economic stagnation or recession occur simultaneously and remain unchecked for a period of time. Stagflation was witnessed by developed countries in 1970s, when world oil prices rose dramatically. Stagflation is when economic growth is stagnant but there still is price inflation. This combination seems contradictory if not impossible.

ii. Three causes of inflation in an economy of country B

1. Demand-Pull Effect

Demand-pull inflation occurs when the overall demand for goods and services in an economy increases more rapidly than the economy's production capacity. It creates a demand-supply gap with higher demand and lower supply, which results in higher prices. For instance, when the oil producing nations decide to cut down on oil production, the supply diminishes. This lower supply for existing demand leads to a rise in price and contributes to inflation. Additionally, an increase

in money supply in an economy also leads to inflation. With more money available to individuals, positive consumer sentiment leads to higher spending. This increases demand and leads to price rises. Money supply can be increased by the monetary authorities either by printing and giving away more money to the individuals, or by devaluing the currency. In all such cases of demand increase, the money loses its purchasing power

2. Cost-Push Effect

Cost-push inflation is a result of the increase in the prices of production process inputs. Examples include an increase in labour costs to manufacture a good or offer a service or increase in the cost of raw material. These developments lead to higher cost for the finished product or service and contribute to inflation.

3. Built-In Inflation

Built-in inflation is the third because that links to adaptive expectations. As the price of goods and services rises, labour expects and demands more costs/wages to maintain their cost of living. Their increased wages result in higher cost of goods and services and this wage price spiral continues as one factor induces the other and vice-versa.

Note that students may add more causes of inflation and please consider his or her points as long as the marks provided above never changes.

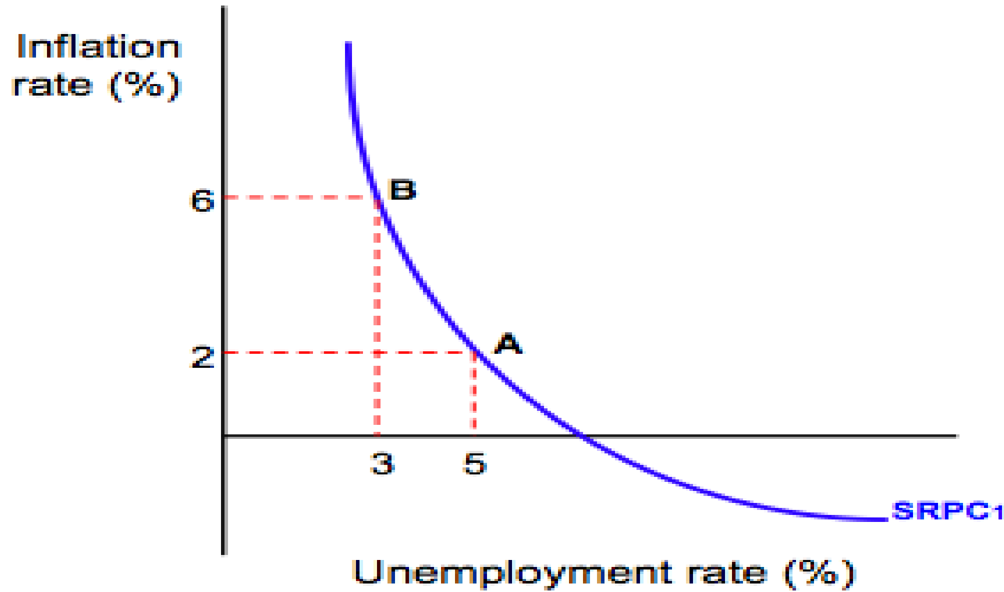
iii. Four control measures Rwanda national bank use to curb inflation

- Credit Control: One of the important monetary measures is monetary policy
- Demonetization of Currency
- Issue of New Currency
- Reduction in Unnecessary Expenditure
- Increase in Taxes
- Increase in Savings
- Surplus Budgets
- Public Debt

b. Relationship between inflation and unemployment using Philips curve

Expected inflation causes people to demand greater wages so that their incomes will keep pace with inflation. By increasing the cost of labor, the short-term increase in employment is reversed back to the natural rate of unemployment. This relationship is summarized in the natural rate hypothesis, which states that unemployment eventually returns to its normal or natural rate, regardless of the inflation rate. As often, inflation is caused by rising wages. If nominal wages are rising faster than inflation, then real wages are rising and consumers can afford to buy more. It is

the growth in consumer spending which is causing inflation. However, if inflation is higher than nominal wages, then real wages will fall and, in that case, consumer spending may fall.



The Phillips curve shows the inverse trade-off between inflation and unemployment. As one increases, the other must decrease. In this image, an economy can either experience 3% unemployment at the cost of 6% of inflation or increase unemployment to 5% to bring down the inflation levels to 2%.

QUESTION SIX

Marking Guide

		Marks
a)	Discussion on three international trade barriers (2 Marks for each barrier discussed)	6
b)	Opportunities from international trade (2 marks each x 2= 4 max of 4 marks)	4
c)	Benefit explained (2 marks each x 3= 6 marks, maximum of 6 marks	6
d)	Benefits (1 mark each x 4= 4 marks, maximum of 4 marks)	4
Total		**20**

Model Answers

a.

i. Common international trade barriers

Language Barriers: When engaging in international trade, it is important to consider the languages spoken in the countries to which you are looking to expand. Does your product messaging translate well into another language? Consider hiring an interpreter and consulting a native speaker and resident of each country. It's also critical to consider the languages spoken by your company's team members based in international offices. Once again, investing in interpreters can help ensure your business continues to operate smoothly.

Cultural Differences: Just as each country has its own makeup of languages, each also has its own specific culture or blend of cultures. Culture consists of the holidays, arts, traditions, foods and social norms followed by a specific group of people. It is important and enriching to learn about the cultures of countries where you will be doing business. When managing teams in offices abroad, selling products to an international retailer or potential client or running an overseas production facility, demonstrating that you have taken the time to understand their cultures can project the respect and emotional intelligence necessary to conduct business successfully.

Managing Global Teams: Another challenge of international trade is managing employees who live all over the world. When trying to function as a team, it can be difficult to account for language barriers, cultural differences, time zones and varying levels of technology access and reliance. To build and maintain a strong working relationship with your global team, facilitate regular check-ins, preferably using a video conferencing platform so you can interact in real time. Research by Gallup shows that employees who have regular check-ins with their managers are three times more likely to be engaged at work than employees who don't.

Currency Exchange and Inflation Rates: The value of a dollar in your country would not always equal the same amount in other countries' currency nor will the value of currency consistently be worth the same amount of goods and services. Familiarize yourself with currency exchange rates between your country and those where you plan to do business. It is also important to monitor inflation rates which are the rates that general price levels in an economy increase year over year, expressed as a percentage. Inflation rates vary across countries and can impact materials and labor costs as well as product pricing.

Nuances of Foreign Politics, Policy and Relations: Business does not exist in a vacuum. It is influenced by politics, policies, laws and relationships between countries. Because those relationships can be extremely nuanced, it is important that you closely follow news related to countries where you do business. The decisions made by political leaders can impact taxes, labor laws, raw material costs, transportation infrastructure, educational systems and more.

ii. Two advantages of International Trade

- Increased revenues

One of the top advantages of international trade is that you may be able to increase your number of potential clients. Each country you add to your list can open up a new pathway to business growth and increased revenues. The 2016 FedEx Trade Index, a national survey of 1,004 small business leaders conducted by Morning Consult shows that business leaders engaged in global trade say they are growing faster and hiring more employees than small businesses who stay stateside.

- Easier cash-flow management

Getting paid upfront may be one of the hidden advantages of international trade. When trading internationally, it may be a general practice to ask for payment upfront, whereas at home you may have to be more creative in managing cash flow while waiting to be paid. Expanding your business overseas could help you manage cash flow better.

- Benefiting from currency exchange

Those who add international trade to their portfolio may also benefit from currency fluctuations. For example, when the U.S. dollar is down, you may be able to export more as foreign customers benefit from the favorable currency exchange rate.

- Enhanced reputation

Doing business in other countries can boost your company's reputation. Successes in one country can influence success in other adjacent countries which can raise your company's profile in your market niche. It can also help increase your company's credibility both abroad and at home. This is one of the advantages of international trade that may be difficult to quantify and therefore, easy to ignore.

- Opportunity to specialize

International markets can open up avenues for a new line of service or products. It can also give you an opportunity to specialize in a different area to serve that market. Being exposed to the realities of the world outside your home base may even spark innovations, upgrades and efficiencies for your products and services. We never know what happens when we open our minds to ideas, feedback and experiences that come from outside the boundaries of our own country.

b. Benefits of world trade organization

- Transparent, predictable and attractive investment regime; up to $12 billion of foreign direct investments can be accumulated in Belarus within 5 years after joining the world trade organization

- Strengthening positions in trade disputes: since the creation of the world trade organization disputes settlement body 60% of disagreements have been resolved during initial consultations

- Participation in the development of new rules and principals of international trade: world trade organization is working on many relevant issues, including e-commerce, streamlining investment procedures engaging small and medium sized enterprises in international trade

- Export diversification: more than $1.3 billion of potential goods and services from Belarus to 164 world trade organization members would be unlocked

- Increase of sovereign credit ratings: for 80% of countries that have joined the world trade organization since 2004, the credit rating in the classification of the Overseas Economic Cooperation Operation (OECO) was increased within 3 years from the date of accession

c. Four benefits of economic liberalization

- Removal of Barriers to International Investing: Investing in emerging market countries can sometimes be an impossible task if the country you are investing in has several barriers to entry. These barriers include tax laws, foreign investment restrictions, legal issues, and accounting regulations all of which make it difficult or impossible to gain access to the country. The economic liberalization process begins by relaxing these barriers and relinquishing some control over the direction of the economy to the private sector.

- Unrestricted Flow of Capital: The primary goals of economic liberalization are the free flow of capital between nations and the efficient allocation of resources and competitive advantages. This is usually done by reducing protectionist policies such as tariffs, trade laws, and other trade barriers.

- Stock Market Appreciation: In general, when a country becomes liberalized, stock market values also rise. Fund managers and investors are always on the lookout for new opportunities for profit.

- Reduced Political Risks: Liberalization reduces the political risk to investors. For the government to continue to attract more foreign investment, areas beyond the ones mentioned earlier have to be strengthened as well. These are areas that support and foster a willingness to do

business in the country such as a strong legal foundation to settle disputes, fair and enforceable contract laws, property laws and others that allow businesses and investors to operate with confidence.

QUESTION SEVEN

Marking Guide

	Marks
a. Compare and contrast monetary and fiscal policy instruments	
Monetary explanation 2 Fiscal Explanation	2
Variables (1 mark each, maximum of 3 marks)	3
Differences Elements controlled by Monetary policy (1 mark each, maximum of 3)	3
Stances of fiscal policy (1 mark each, maximum of 2)	2
b. Monetary and fiscal policies harmonization	
Reasons (1 mark each, maximum of 2)	2
Importance- consider other importance outside the model answer	4
c. Effects	1
Graph and explanations (2 marks for graph= 1 mark for explanation= 3 marks)	3
Total	**20**

Model Answers

a. Monetary and fiscal policies

i. Comparison between Monetary and Fiscal policies

▪ **Monetary policy** is the process by which the monetary authority of a country or a tool used by central bank to control the supply of money, often targeting a rate of interest for the purpose of promoting economic growth and stability. The official goals usually include relatively stable prices and low unemployment. Monetary theory provides insight into how to craft optimal monetary policy. It is referred to as either being expansionary or contractionary, where an expansionary policy increases the total supply of money in the economy more rapidly than usual, and a contractionary policy expands the money supply more slowly than usual or even shrinks it.

▪ **Fiscal policy** is the use of government revenue collection (taxation) and or expenditure (spending) to influence the economy. Fiscal policy refers to changes in government expenditures and taxes to achieve particular economic goals such as low unemployment, price stability; and economic growth.

The main instruments of fiscal policy changes in the level of government taxation and changes in the level of government spending to affect the following variables in the economy:

✓ Aggregate demand and the level of economic activity;

✓ The distribution of income (charging rich people and help the more vulnerable);

✓ The pattern of resource allocation within the government sector and relative to the private sector.

ii. Differences between monetary and fiscal policies

Monetary policy is the process by which the government, central bank, or monetary authority of a country controls:

- the supply of money
- availability of money, and
- cost of money or rate of interest to attain a set of objectives oriented towards the growth and stability of the economy.

Fiscal policy refers to the use of the government budget to influence economic activity. The Two main stances of fiscal policy are:

- Expansionary fiscal policy is more appropriate during recessions.
- Contractionary fiscal policy is better when government spending is lower than tax revenue.

b. Monetary and Fiscal Harmonization

The objectives of monetary and fiscal policies are ultimately the same. This is true at least in theory because both policies have to exert certain influences upon economic variables such as output, prices, employment level and others. For this reason, monetary and fiscal policies have to supplement each other in order to accomplish their overall objectives of high level of employment and stability.

Despite this, the instruments employed to carry out fiscal policy may influence monetary and credit conditions. Accordingly, monetary policy will have little or no effect especially when the treasury is pursuing a completely divergent policy from the central bank. Sometimes, the treasury adopts an expansionary policy while the central bank attempts to restrict credit.

vital importance of harmonizing between the Government policies and the Central Bank policies

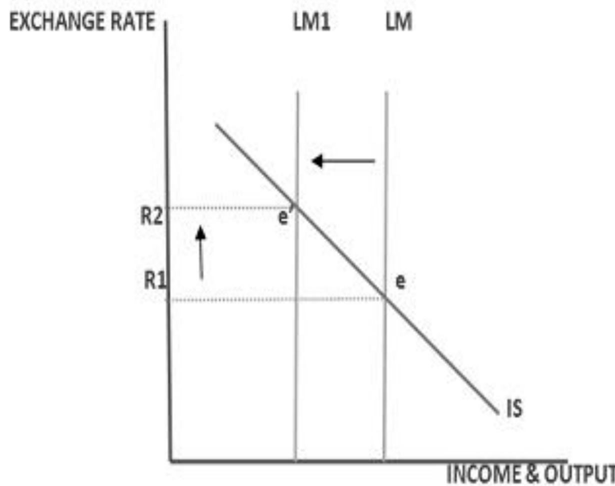
Many countries have shown that a central bank has a degree of independence of the government proper of making economic analyses and hold views which are more detached and objective than those of a government department. Many governments have learned to value and to use the sort of independent and objective advice on monetary and other aspects of economic policy which central banks have been able to give. On matters of vital interest to the state, however, it must be recognized that, it would be impossible for the Central Bank to adopt a policy or pursue a course of action contrary to the policy of the Government of the day.

No agency which is a creature of the Government can be entirely independent of the Government. While the Government may be prepared to give an independent regulatory agency rather wide discretion in a field such as that of money, there is no gain-saying that, in the last analysis, the Government must assume responsibility for monetary policy as for other policies. The Governor and the appointed member of the Monetary Board cannot help being acutely conscious of the fact that, since no Parliament can bind its successors, their independence and tenure in office

Under the proposed legislation is limited by the ultimate power of the Government to change the law. The degree and independence of the Central Bank is likely to vary from time to time. For example, central banks can ordinarily act more independently in stable, peace-time economic conditions, than in time of war or other national emergency. They also tend to take stronger stands on issues which are primarily monetary in character than on related issues which may simply have monetary repercussions.

c. Effects of contractionary monetary policy on the exchange rate

Contractionary monetary policy, by driving up domestic interest rates, would cause the currency to appreciate and the National Income (GDP) to decrease.



A contractionary Monetary policy from LM to LM1 will shift exchange rate from e to e’ which also affects negatively the Gross domestic Product (GDP).

END OF MARKING GUIDE AND MODEL ANSWERS